Proposed Accounting Rule Could Boost Per-Share Earnings of Some Companies

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HEARD ON THE STREET

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Attention, Wall Street: The accountants are coming but, believe it or not, the news could be good for some stock prices.

The Financial Accounting Standards Board, the chief rule maker for accountants, has proposed an accounting rule that would reduce the dilutive effect of stock options, warrants and convertible securities on per-share earnings, or EPS. The proposal was made weeks ago but hasn't gotten much scrutiny until now.

This would boost some companies' EPS and reduce their price/earnings ratios. And some financial analysts believe that when the P/E ratio goes down, the price of the stock will tend to go up. "The lower P/E will encourage technical market analysts to conclude that the stock should be trading at higher levels," says Robert Willens, an accounting specialist with Lehman Brothers, a major brokerage firm.

Mr. Willens says that the industries likely to benefit most from the proposed change are banking, drugs, high technology, metals, paper and other heavy industries. Those that will benefit least include autos, consumer goods, foods, tobacco and nondurable goods, he adds.

Whether the proposed changes would make it easier or harder for investors to weigh stock risks could become a subject of debate in the accounting community. But if the changes are approved by the FASB—which is likely — accountants would start calculating two new bottom lines beginning in 1997. And while the changes wouldn't occur until next year, "the Street will be aware of the proposal when looking at stock-price potential right now, so it could affect stock prices a lot sooner," Mr. Willens says.

According to Bear Stearns Cos., another big brokerage firm, companies that would get the biggest boost to EPS if the accounting change took place today, based on their recent stock-market performance and EPS reports, are TII Industries, EPS up 29%; Safeway, EPS up 19%; Robotic Vision, EPS up 17%, and Sterling Software, EPS up 16%.

"The higher EPS may increase the relative valuations in the stock market of companies with piles of options, warrants and convertible securities," says Pat McConnell, an accounting analyst with Bear Stearns.

Under the new accounting proposal, something called basic EPS, reflecting no dilution from options or warrants, would replace the current primary EPS, which reflects such dilution. Thus, for companies that issued options or warrants during the period being reported, basic EPS would be higher—in some instances much higher—than the current primary EPS figure.

For example, based on Monday's close on the New York Stock Exchange of 72⅞ for Sterling Software's common shares, the company's P/E ratio would be 24.9 under the FASB's new proposal for basic EPS, compared with 28.7 under current accounting using primary EPS. To get back up to the 28.7 EPS under the new standards, Sterling's common would have to rise to 84, a 15% increase. (These examples employ Sterling's net income of $58 million for the year ended Sept. 30, 1994, to calculate EPS, as is done in the accompanying table

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The Biggest Beneficiaries

Accounting proposal boosts earnings per share

COMPANY	NEW BASIC EPS[1]	% INCREASE OVER CURRENT EPS[2]
TII Industries	$0.67	29%
Safeway	2.33	19
Robotic Vision	0.74	17
Sterling Software	2.93	16
Comdata Holdings	1.02	15
RJR Nabisco[3]	1.43	15
Silicon Graphics	1.44	12
EMC	1.29	10
Maxim Integrated Prod.	0.63	9
Microsoft	2.50	8

[1]Based on calendar 1994 or fiscal 1995 figures
[2]Primary earnings per share
[3]Based on 5-for-1 reverse split
Source: Bear, Stearns & Co.

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Proposed Rule Could Boost Earnings Per Share, And Thus Stock Prices, of Some Companies

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compiled by Bear Stearns.)

And diluted EPS, based on the average number of shares during the period, would replace the current fully diluted EPS, which is based on either the average number of shares or the total number at the end of the period, whichever is higher. The new diluted figure would show a higher EPS for companies whose stock outstanding rose during the period.

Are these changes really good for investors? Some accountants worry that companies that issue a lot of stock options could use the new system to hide the risk that a flood of new shares could push down the stock price. But other accountants argue that the current rules are overly complex, sometimes arbitrarily overstating the risk of dilution.

Is it the FASB's intention with this new accounting proposal to boost the stock price of some companies more than others? Not really, says Norman Strauss, national director of accounting standards for accountants Ernst & Young. Mr. Strauss says that the accounting rule-making body proposed the change in EPS calculations earlier this year to move U.S. accounting standards more in line with all other major countries, which figure EPS with methods similar to those being proposed.

"The change is to get the U.S. more in line with international harmonization of accounting standards so that major countries can have similar accounting" for comparison of the bottom line of multinational companies and businesses that operate across many borders, Mr. Strauss observes. Comments on FASB's EPS proposal are due by May 31, with a final rule to be issued later this year.

Bear Stearns's Ms. McConnell notes that while most financial analysts use the fully diluted EPS figure in making their analyses, most financial services, including the Dow Jones News Service, Standard and Poor's and Bloomberg use primary EPS in their reports. So users of these services will definitely notice the higher EPS of those companies whose basic EPS is a lot higher than their current primary EPS, she says.

Not surprisingly, companies that would benefit from the proposed accounting change are generally happy with FASB's new approach. "We always like to be at the head of the list when it comes to good news" about any positive developments related to the company's stock price, says Timothy J. Roach, president ot TII Industries, a specialty electrical products maker based in Copiague, N.Y. Mr. Roach says that companies usually don't look forward to new accounting rules by the FASB, which often result in lower reported profits. "So this change resulting in a less conservative effect on our earnings does surprise me," he adds.

But F.J. Dale, group vice president, finance, of Safeway, a supermarket chain based in Oakland, Calif., is more skeptical. The FASB proposal, which shows Safeway's basic EPS rising by 19% over current primary EPS, "could be misleading to investors" because most financial analysts look at fully diluted EPS, Mr. Dale asserts. He estimates that Safeway's diluted EPS under FASB's proposal would rise only 2 cents to 3 cents per share compared with the 37-cent increase from the current primary to FASB's proposed basic EPS figure. "Still, it's the first time that the accountants have suggested something that would increase our EPS," he says.

At Robotic Vision Systems, a maker of three-dimensional inspection and measurement products based in Hauppauge, N.Y., Robert H. Walker, executive vice president, finance and administration, says that Robotic Vision is particularly happy because its stock price, which quadrupled in 1995 to a high of 27¾ in Nasdaq Stock Market trading, has recently been hammered by bad news for companies such as Robotic Vision that are in industries related to semiconductors.

"Our stock price has dropped as low as $12.50, so we can use all the help we can get," says Mr. Walker.

George H. Ellis, executive vice president and chief financial officer of Sterling Software, Dallas, Tex., says that the FASB proposal "will help our company big time in planning our operations to take the volatility out of the stock market in calculating our EPS." Since many analysts look at a company's fully diluted EPS which cannot be calculated until a period ends because it uses the higher of average or period-end shares, using average shares during the period as proposed by FASB will "give us a better chance to maintain EPS momentum," Mr. Ellis says.

"The impact of last minute swings in the number of our shares on our stock price has been difficult to communicate to our operating folks," Mr. Ellis declares.

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